98TH CONGRESS
1st Session

COMMITTEE PRINT

WMCP 98–10

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

DESCRIPTION OF LIFE INSURANCE INCOME TAX PROPOSAL

JULY 14, 1983

U.S. GOVERNMENT PRINTING OFFICE

22-645 O

WASHINGTON : 1983

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INTRODUCTION

The Subcommittee on Select Revenue Measures of the Committee on Ways and Means has scheduled a further hearing on the Federal income tax treatment of life insurance companies and products for July 28, 1983.

This committee print contains a copy of a press release (Part I) announcing a further hearing by the Subcommittee on Select Revenue Measures of the Committee on Ways and Means on the tax treatment of life insurance companies and their products. The print also contains a description of a proposal (Part II) that was advanced by Subcommittee Chairman Stark and Representative Moore to provide a framework for discussion of the tax treatment of life insurance products and companies at that hearing.

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I. THE PRESS RELEASE

On July 14, 1983, the Subcommittee on Select Revenue Measures of the Committee on Ways and Means issued the following press release:

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FOR IMMEDIATE RELEASE
July 14, 1983

PRESS RELEASE #6
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
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THE HONORABLE FORTNEY H. (PETE) STARK, CHAIRMAN (D., Calif.)
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
COMMITTEE ON WAYS AND MEANS
ANNOUNCES FURTHER HEARINGS ON THE
TAX TREATMENT OF LIFE INSURANCE COMPANIES AND THEIR PRODUCTS

The Honorable Fortney H. (Pete) Stark (D., Calif.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, today announced further hearings on the tax treatment of life insurance to be held on Thursday, July 28, 1983, in the Committee's main hearing room, 1100 Longworth House Office Building, beginning at 9:30 a.m. Testimony will be received from invited witnesses only, including the Department of the Treasury and selected representatives of the life insurance industry.

The Subcommittee on Select Revenue Measures held hearings on the tax treatment of life insurance companies and their products on May 10 and 11, 1983 (see Press Release #3). Based on the testimony presented at those hearings, Representative Stark (D., Calif.) and Representative Henson Moore (R., La.) have developed a proposal for discussion which has as its goal a simplification of the present tax structure while reflecting the individual purpose and character of life insurance transactions.

In undertaking to develop a permanent structure in substitution for the 1959 Act, Mr. Stark and Mr. Moore took careful notice of the widely held view that the 1959 Act had many inadequacies that defied rational analysis. The comment of one court in interpreting the Act is typical:

> "These complex and obscure provisions bear all the earmarks of a conspiracy in restraint of understanding." Lincoln Nat. Life Ins. Co. v. United States, 582 F.2d 579 (Ct.Cl. 1978) at 583 n.1.

Mr. Stark and Mr. Moore believe that the proposal represents a method of tax treatment for the life insurance industry and their products which is both rational and consistent with economic reality.

In setting forth the proposal, Mr. Stark and Mr. Moore indicated that they believe that it represents a sound starting point for developing a final legislative product. The proposal is the result of many hours of work at the staff level, including extensive consultation with representatives from all segments of the life insurance industry. If the proposal imposes any unfair or unintended result on either a single company or segment of the life insurance industry, Mr. Stark and Mr. Moore encourage such affected taxpayers to bring these problems to the attention of the Subcommittee through the hearings or in written submissions. Specifically, it is requested that witnesses furnish information indicating the impact of this proposal on individual companies. In addition, it is requested that witnesses provide views as to the appropriate level of aggregate industry tax burden. Following the hearings and the receipt of written comments, it is Mr. Stark's intention to begin legislative consideration of the proposal and development of a bill by the Select Revenue Measures Subcommittee.

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A summary of the proposal is set forth below. A detailed explanation of it may be obtained from either the Joint Committee on Taxation, Room 1015 Longworth House Office Building, Washington, D.C. 20515, (202)225-2647, the Subcommittee on Select Revenue Measures, Committee on Ways and Means, 1136 Longworth House Office Building, Washington, D.C. 20515 (202)225-9397, or Office of the Minority Counsel, Committee on Ways and Means, 1106 Longworth House Office Building, Washington, D.C. 20515 (202)225-4021.

Proposal Advanced by
Chairman Stark and Representative Moore
for Discussion at July 28, 1983 Hearings

I. Single Phase Tax Structure, Using a Stock Company Model -- Company taxable income would be computed on a total income approach, making no distinction between investment and underwriting income and expenses.

II. Treatment of Reserves -- Generally, a deduction for increases in reserves would be allowed where the reserves are the higher of minimum State law reserves or cash surrender value of the contract. With respect to annuity contracts prior to the annuity starting date, a deduction would be allowed for only the increase in the cash value of the contract; after the annuity starting date, increases and decreases in reserves will be taken into account under the general rule. Present-law treatment of accident and health insurance business would be retained.

III. Definition of Life Insurance

A. The temporary guidelines on universal life insurance contracts would be extended to all life insurance contracts, strengthened, and made permanent.

B. For contracts that fail to meet the definition at any time, the pure insurance portion of the contract would be treated as term life insurance exempt from income tax under section 101, and the cash surrender value is treated as deposit fund the income on which is currently taxable.

IV. Ownership Differential

A. The ownership differential would be determined on the basis of a return on equity and would operate as a limitation on the deductibility of policyholder dividends.

B. Equity (i.e., the excess of assets over liabilities) would be determined in a manner that basically relies on the annual statements required for State regulatory purposes, but adjustments would be made to the assets and liabilities to compute an equity measurement that more nearly reflects the measure of equity that would result from using generally accepted accounting principles (GAAP).

C. The rate of return to be used in computing the ownership differential would reflect market returns on both equity and debt.

V. Small Company Treatment -- A special deduction for small companies would be located in a single provision. The application of small company treatment would reflect both asset size and economic income, but not the length of time for which the company qualifies as a small company.

VI. Taxable Income Adjustment -- It is anticipated that this proposal would generate revenue of several hundred dollars less than the revenue estimates projected for the expiration of the temporary provisions at the time the Tax Equity and Fiscal Responsibility Act of 1982 was being considered. To achieve this

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result, all life insurance companies would be allowed a deduction for an amount equal to approximately 25 percent of their otherwise taxable income. This deduction would be computed on the basis of an affiliated group of life insurance companies using an 80-percent ownership test.

VII. Tax-Exempt Income -- Generally, the present rules for allocating tax-exempt income between policyholders and the company would remain.

VIII. Annuity Rules

A. Present-law rules with respect to application of the exclusion ratio after the annuity starting date and partial surrenders or cash withdrawals prior to the annuity starting date would remain unchanged.

B. Generally, the restrictions on income distributions from annuity contracts would be conformed with those applicable to distributions from IRA accouants.

IX. Policyholder Loans (Code sec. 264) -- No tax deduction would be allowed for interest paid on loans from life insurance policies to the extent the aggregate amount of such loans exceeds a certain amount.

X. Computation of Investment in the Contract -- Upon any surrender of or cash withdrawl from a life insurance policy, the aggregate premiums paid would be reduced by the cost of term insurance protection provided prior to such surrender or withdrawal in arriving at a policyholder's investment in the contract for purposes of computing the income of the contract.

XI. Consolidated Returns -- Any deduction or limitation based on the income of the company should be applied on an affiliated group basis.

XII. Definition of Life Insurance Companies -- For purposes of determining whether a company qualifies as a life insurance company, funds held with respect to contracts that do not involve permanent purchase rate guarantees would not be treated as insurance reserves.

XIII. Reinsurance -- The present-law rules with respect to reinsurance transactions would be retained.

XIV. Stock Subs of Mutuals -- Stock life insurance subsidiaries that are 80 percent owned by mutual life insurance companies would be treated as mutual companies for tax purposes.

XV. Computation of Foreign Tax Credits -- Every company would compute its foreign tax credit limitation on the basis of the ratio between foreign source taxable income and worldwide taxable income.

XVI. Exclusion from Income of the Cost of Group Term Insurance (Code sec. 79) -- The nondiscrimination rules under section 79 (d) would be extended to retired employees and employees under discriminatory plans would be barred from using the uniform cost table.

XVII. Effective Dates and Transition Rules

A. Generally, the effective date for provisions dealing with the taxation of life insurance companies would be January 1, 1984.

B. Transitional rules would be provided for provisions affecting policyholders in order to prevent abusive situations or hardship to individual taxpayers.

C. Tax treatment of current amounts in the Phase III account of a stock company is unresolved, but several options will be considered by the Subcommittee.

Written Comments

For those who wish to file a written statement for the printed record of the hearing, twenty-five copies are required and may be submitted to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102 Longworth House Office Buidling, Washington, D.C. 20515, by close of business, July 28, 1983.

II. DESCRIPTION OF PROPOSAL

The subcommittee in its press release of July 14, 1983, announced a hearing to seek comment on the effect, on particular companies, of the specific proposal outlined below. The proposal, advanced by Chairman Stark and Representative Moore, is intended as a comprehensive rewrite of the provisions of Part 1 of Subchapter L of the Internal Revenue Code governing the tax treatment of life insurance companies and their products.

A. Company Taxation

Overview

In lieu of the present law three-phase pattern of taxation which applies to life insurance companies, a new single-phase tax structure would be provided. This structure would embody the tax rules applicable to corporations generally except that certain special rules would apply to address issues unique to the life insurance industry. The principal special rules would include (1) a deduction for additions to reserves based on the greater of any cash surrender value under a contract or the minimum reserve for the contract under State law, (2) a limitation on the deductibility of policyholder dividends designed to ensure that mutual companies are taxed at the company level on a minimum return on the equity of the company, (3) a special deduction for small life insurance companies, and (4) a generally applicable deduction which would reduce the aggregate tax burden on the life insurance industry.

Under present law, different life insurance companies may be taxed on distinctively different tax bases. As a consequence, life insurance companies may derive varying degrees of benefit from the special deductions and reserve computation rules of present law. For example, the 2-percent-of-premiums deduction for accident and health insurance and group life insurance results in no tax savings for a company taxed on investment income. A company taxed on its entire gain from operations may not receive a full benefit from the deduction because of the limitation on special deductions and the policyholder dividend deduction, while a company that is eligible for a partial deferral of underwriting income receives only half of that benefit. Under a single-phase structure all deductions would benefit companies equally except to the extent that the final tax burden is affected by the special deduction for small companies or the limitation on policyholder dividends of mutual companies.

Computation of the deduction for reserves

Life insurance companies must maintain reserves in accordance with State regulatory requirements. These State rules are designed to ensure the solvency of the companies rather than to measure economic income. In addition, companies enjoy a large margin of

flexibility in computing their reserves. Under the proposal, rules would be provided governing the deduction for policyholder reserves that would more closely reflect the company's economic income and provide for uniform treatment of various companies regardless of the particular assumptions they make in computing reserves under State law.

As a general rule, a life insurance company could deduct as an addition to its life insurance reserves the increase from the prior year's tax reserves to the higher of the actual surrender value of the contract or the minimum State law reserve. For this purpose, the actual surrender value would be computed by reference to the provisions in any contract guaranteeing cash values reduced by any penalties or charges which would be imposed upon surrender. Minimum State law reserves would be defined as the reserves which would be required if the company (in computing its reserves and for contract purposes) used (1) a full preliminary term method of computing reserves, (2) the highest assumed interest rate permitted under State law, and (3) the most recent mortality table allowed under State law. The highest rate and most recent mortality table would be the highest rate and most recent table that could be used at the time the contract is issued in the State in which the contract is issued. Alternatively, the company could elect to use an interest rate and mortality table which represents the highest rate and most recent table permitted by the largest number of all States. For purposes of computing tax reserves, no revaluation of reserves from preliminary term to net level premium reserves would be permitted.

Thus, under these rules, if a company elects to maintain for State purposes a reserve that is higher than both the current liability of the company to the policyholder and the minimum reserve which the State would find to be adequate, then that excess would be treated as a voluntary reserve rather than a proper measure of liabilities. Generally, no deductions would be allowed for increases in contingency or voluntary reserves, or deficiency reserves. Likewise, no special deductions would be allowed for nonparticipating contracts, accident and health insurance contracts, or group life insurance contracts.

With respect to deferred annuity contracts, prior to the annuity starting date, the deduction for increases in reserves would be measured only as increases in the cash value of the annuity. After the annuity starting date, increases and decreases in reserves would be taken into account under the general rule. With respect to accident and health insurance contracts, unearned premiums and unpaid losses would continue to be computed as under present law.

Ownership differential (limitation on deduction for policyholder dividends)

Mutual life insurance companies are owned by their policyholders. These policyholders receive distributions from the company which may represent price reductions or other policyholder benefits, returns on the policyholders' investment in the enterprise, or both. With respect to both stock and mutual companies, the propos-

al endeavors to allow a full deduction for amounts paid to policyholders in their capacity as customers.

In the case of mutual companies, the deduction for policyholder dividends (including excess interest and premium adjustments) would be limited so that a company level tax would be levied on that portion of the company's income which represents the earnings generated by the policyholders' investment in the company. In particular, the equity of a mutual life insurance company that is held for its policyholders in their capacity as owners would be computed on the basis of State regulatory and Federal tax information to approximate the equity of a stock life insurance company as computed under generally accepted accounting principles (GAAP). However, complex computations not otherwise required for State regulatory or Federal tax purposes would not be required. Thus, equity generally would be the excess of assets over liabilities as shown on the annual statement required under State law, except that assets would be increased by the amount of any nonadmitted financial (investment) assets and liabilities would be adjusted (1) to reflect the Federal tax computation of reserves described above, (2) to eliminate any reserve for securities valuation (net of tax effect on any mandatory securities valuation reserves), and (3) to eliminate any provision for policyholder dividends which are not apportioned or which are apportioned but would not be payable at year-end if the contract were surrendered at that time (without regard to the possible payment of termination dividends).

The company would be treated as earning, as a pre-tax return to their policyholders in their capacity as owners, a return on this equity equal to an amount determined under rules established in the tax law. Specifically, the rate of return would be set and adjusted to reflect the rate of return enjoyed by commercial enterprises generally. Initially, this rate would be set at 23 percent. An adjustment would be made for post-1982 changes in the three-year moving average of a combined average rate determined by taking into account the rate of return earned by stock life insurance companies on the tax equity defined above, the rate of return earned by the top 400 industrial corporations, and the rate on one-year Treasury bills (grossed up by the corporate tax rate).

If the taxable income of the company before policyholder dividends is less than the equity return, then that lesser amount would be subject to income tax. If, however, the taxable income before policyholder dividends exceeds the return on equity, the company would be taxed on its taxable income reduced by policyholder dividends but not below the return on equity.

Stock life insurance subsidiaries of mutual companies

Stock life insurance subsidiaries that are 80 percent owned by mutual life insurance companies would be treated as mutual companies for tax purposes. The limitation on policyholder dividends would be applied to stock subsidiaries according to the following rules:

1. In the case of a mutual parent and a stock subsidiary filing separate returns, the limitation on policyholder dividends would be applied to members of a mutual company's affiliated group separately; the mutual parent's stock ownership

in a subsidiary filing a separate return would not be included in the computation of the parent's equity base.

2. In the case of consolidated returns, the ownership differential provision would be applied to the members of an affiliated group filing a consolidated return on a aggregate basis. In application, the aggregate return on equity would be allocated in the same proportion as the individual member's policyholder dividends bears to the aggregate policyholder dividends paid by the affiliated group of life insurance companies filing the consolidated return.

Treatment of small companies

Under present law, a large number of smaller life insurance companies achieve substantial reductions in their taxable income through the use of one or more special provisions such as the revaluation of preliminary term reserves and the deferral of a portion of underwriting income. The amount of the reduction in taxable income achieved through these provisions varies from company to company. There does not appear to be any relationship between the size of a company and its ultimate tax liability.

Under the proposal, small life insurance companies would reduce their taxable income by 60 percent of its first $1 million in taxable income. This deduction would phase out as taxable income increases from $1 million to $4 million. Thus, a company with $4 million or more in taxable income would not be entitled to any small company deduction. Likewise, any company with more than $500 million in assets as reported on the Annual Statement would never be allowed small company treatment.

In determining eligibility for the small company deduction and the amount of the deduction, the assets and taxable income of a company would be computed on the basis of an affiliated group including both insurance and noninsurance members using an 80-percent ownership test.

Taxable income adjustment

It is anticipated that this proposal would generate revenue of several hundred million dollars less than the revenue estimates projected for the expiration of the temporary provisions at the time the Tax Equity and Fiscal Responsibility Act of 1982 was being considered. To achieve this result, all life insurance companies would be allowed a deduction for an amount equal to approximately 25 percent of their otherwise taxable income. This deduction would be computed on the basis of an affiliated group of life insurance companies using an 80-percent ownership test.

Tax-exempt income

Under present law, interest accruing on policyholder reserves is treated as funded proportionately out of taxable and tax-exempt income. These rules allocating tax-exempt income between the policyholders and the company would be retained except that the policyholder's share would include all amounts credited or paid to policyholders.

Reinsurance

The present law rules with respect to reinsurance transactions between life insurance companies and other insurance companies (i.e., denial of an interest deduction on indebtedness incurred in connection with reinsurance agreements, and Treasury allocation authority for related party coinsurance contracts) would be retained. Similarly, the present law treatment of policyholder dividend reimbursements under reinsurance contracts (the policyholder dividends are treated as paid by the ceding company and not by the reinsurer) would be retained.

Foreign tax credit

Under present law, different life insurance companies may have to calculate the foreign tax credit limitation on different bases. A company taxed on investment income may be able to credit otherwise creditable foreign income taxes imposed on underwriting income only if it generates sufficient foreign source investment income. This situation could encourage companies to invest abroad rather than in the United States. Under this approach, every life insurance company would compute its foreign tax credit limitation on the basis of the ratio between foreign source taxable income and worldwide taxable income, i.e., the rule generally applicable to other taxpayers.

Definition of life insurance companies

For purposes of determining whether a company qualifies as a life insurance company, funds held with respect to contracts that do not involve permanent purchase rate guarantees would not be treated as insurance reserves.

B. Individual Taxation

Definition of life insurance

Present law contains temporary guidelines for flexible premium life insurance products (e.g., universal life and adjustable life) for determining whether death benefits qualify as life insurance benefits exempt from income tax. Under the proposal, the temporary guidelines would be extended to all life insurance products, strengthened, and made permanent. Thus, contracts meeting either of the following alternative tests would be treated as life insurance for tax purposes:

Alternative 1

(a) Total premiums paid for a level death benefit, at any time, may not exceed the sum of the premiums paid under a 10-pay life contract (a contract which has a minimum of ten level annual premiums), or the sum of the level premiums paid over the life of the contract, assuming that the contract matures no earlier than age 95; and

(b) The face amount of the contract must be at least 250 percent of the cash value of the contract for policyholders of age 40 or less, phasing down four percent each year until the fact

amount of the contract is 110 percent of the cash value (assuming the contract matures no earlier than age 95).

Alternative 2

The cash value of the contract cannot exceed the cash value computed under a 10-pay life contract maturing at age 95 (with a general exception for reasonable single premium paid-up additions).

For contracts that fail to meet the definition at any time, the pure insurance portion of the contract (the difference between the face amount and the cash surrender value) would be treated as term life insurance exempt from income tax under section 101, and the cash surrender value would be treated as a deposit fund and income earned on the fund would be taxable currently.

Annuities

Present law provides explicit rules for the computation of income on annuity contracts and a penalty on early income distributions. Under the proposal, the rules relating to the computation of income would not be changed. With respect to investments in deferred annuities, the penalty provision on income distributions would be conformed generally to those applicable to distributions from individual retirement accounts. The present 5-percent penalty for premature distributions would not be increased. Specifically, the entire interest in a deferred annuity would have to be distributed not later than the close of the taxable year in which the policyholder reaches age 70½, or over the life of the policyholder (and spouse) or over a period not extending beyond the life expectancy of the policyholder (and spouse). Loan proceeds based on the value of the annuity contract would continue to be treated as cash withdrawals.

Generally, the penalty on premature distributions of income, which would continue at the present law level of five percent, would not apply to income distributions (1) on or after the policyholder reaches age 59½, (2) upon the death of the policyholder, (3) upon the policyholder becoming disabled, (4) if the distribution is one of a series of substantially equal periodic payments for life or for at least 10 years, or (5) from a qualified pension plan.

Policyholder loans

Under the proposal, no tax deduction would be allowed for interest paid on loans from life insurance policies to the extent the aggregate amount of such loans exceeds $50,000 for any person.

Computation of investment in the contract

Upon any surrender of or cash withdrawal from a life insurance policy, the aggregate premiums paid would be reduced by the cost of term insurance protection provided prior to such surrender or withdrawal in arriving at a policyholder's investment in the contract for purposes of computing the income of the contract. The cost of term insurance would be that computed according to a standard table specified in the statute or, if lower, the actual mortality cost stated in the contract (if any).

Group term insurance

The nondiscrimination rules under section 79(d) would be extended to retired employees and employees under discriminatory plans would be barred from using the uniform cost table.

C. Effective Dates and Transition Rules

Company taxation

Generally, the effective date for provisions dealing with the taxation of life insurance companies would be January 1, 1984. Thus, the policyholder dividend limitation would be effective for all business as of January 1, 1984. Likewise, companies would be required to revalue all reserves under the new rules for tax purposes as of January 1, 1984; any difference between the tax reserves computed under present law and the reserves computed under the new rules would be taken into account pro rata over ten years.

Individual taxation

Changes in the tax treatment of annuities would be effective on the date of enactment.

The provision for adjusting a policyholder's investment in a contract to take into account the term insurance protection received would be effective for all contracts purchased after January 1, 1984.

The definition of life insurance would be effective January 1, 1984 (January 1, 1985, in the case of certain debit insurance).

The cap affecting the deduction of interest on policyholder loans would apply to all policies but only with respect to future loans, effective immediately.

Previously deferred amounts

There is no permanent provision dealing with amounts currently in the policyholders' surplus account (phase III account) in the proposed new tax structure. Under the 1959 Act, a 50-percent deferral of underwriting gains to the policyholders' surplus account was intended to moderate fluctuations in underwriting income and to effectuate a transition from prior law. Since enactment of the 1959 Act, experience has not demonstrated the type of fluctuations in underwriting income which was of concern at the time of enactment. In addition, extended loss carryover periods generally have been provided.

The subcommittee may wish to provide rules for collecting the tax on amounts currently retained in the policyholders' surplus accounts. Several options may be considered by the subcommittee:

(1) Amounts in the policyholders' surplus account could be taken into income pro rata over some extended period of time.

(2) Losses incurred by companies could be required to be offset against amounts in the policyholders' surplus account prior to being carried back or carried forward.

(3) Amounts in the policyholders' surplus account could be taken into income pro rata as existing policies terminate.

(4) Existing amounts in the account could be subject to tax only in the same circumstances as under the 1959 Act.

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ERRATA SHEET TO SUBCOMMITTEE ON SELECT REVENUE MEASURES' COMMITTEE PRINT

DESCRIPTION OF LIFE INSURANCE TAX PROPOSAL DATE JULY 14, 1983

On page 9 insert after the second complete paragraph the following sentence:

> The 23 percent rate initially established was derived by applying the 3-factors set forth to the 3-year period prior to 1982. As indicated, it would be adjusted as described for the first year to which it would be applicable, 1984.